

Part III. Administrative, Procedural, and Miscellaneous

26 CFR 601.201: Rulings and determination letters
(Also Part I, §1256(g)(9))

Rev. Proc. 2002–11

SECTION 1. PURPOSE

This Revenue Procedure contains procedures that an exchange may follow to enable the Internal Revenue Service to determine whether certain persons trading on that exchange qualify as “dealers” under section 1256(g)(9) of the Internal Revenue Code (the “Code”). It is expected that, after the issuance of a letter ruling to a specific exchange determining whether a specific category of persons trading securities futures contracts (and options on such contracts) on that exchange qualifies for dealer status under section 1256(g)(9), the Service will publish the same conclusion in a revenue ruling.

SECTION 2. BACKGROUND

The Commodity Futures Modernization Act of 2000, enacted as part of the Consolidated Appropriations Act, 2001 (Public Law 106–554, 114 Stat. 2763), authorizes the trading of securities futures contracts, a new type of derivative financial product. In general, gain or loss is recognized on securities futures contracts upon disposition, and the character of that gain or loss is determined by newly enacted section 1234B of the Code.

The timing and character of gains and losses on *dealer* securities futures contracts (and options on such contracts), however, is determined under section 1256. Dealer securities futures contracts are subject to mark-to-market treatment, and gains or losses are treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. Section 1256(a). For purposes of the application of section 1256 to dealer securities futures contracts (and options on such contracts), a person is a *dealer* if the Secretary of the Treasury determines that the person performs functions with respect to such options or contracts similar to the functions performed with respect to stock options by persons registered with a national securities exchange as a market maker or specialist in listed options.

In Notice 2001–27, 2001–13 I.R.B. 942, the Service and the Treasury Department requested comments and suggestions regarding both the substance of the required determinations and the manner in which they should be made. Numerous

comments have been received regarding criteria that could be used to identify dealers in securities futures contracts (and options on such contracts). In addition, staff of the Service and Treasury initiated numerous conversations with both regulators and various exchanges. These ongoing conversations are expected to continue unabated.

The exchanges on which securities futures contracts and options may be traded, however, are still developing rules that will govern trading. In addition, certain of the regulatory requirements that will be imposed by the Securities and Exchange Commission and the Commodity Futures Trading Commission have not yet been issued in final form, and the rules promulgated by some exchanges may differ in important respects from those governing the trading of any other products.

During the current period, when trading rules are being developed, it is important for the Service and Treasury to provide certainty for taxpayers while at the same time not constraining the development of trading structures for the new markets. Given the likely diversity of trading platforms and the potential for new trading models, the Service and Treasury have determined that encouraging exchanges to apply for case-by-case determinations while they are developing their trading rules is preferable to either writing general rules before the trading structures are known or waiting until the structures are finally established and then making the exchanges wait for a general rule to be crafted.

The issuance at this time of general guidance for determining dealer status would risk constraining the development of the structures for the new markets. On the other hand, if general guidance is not issued now, the absence of an interim process for securing dealer determinations could impair the ability of the exchanges to adapt their proposed trading systems to the requirements for achieving dealer status for market participants. As a result of the flexibility inherent in the process of obtaining a letter ruling, an exchange will have an opportunity, if it so desires, to make adjustments in its proposed trading practices should those be needed to secure dealer status for particular groups of traders.

Under the procedures set forth below, if an exchange is one on which securities futures contracts (or options thereon) are, or are expected to be, traded, the exchange may request a letter ruling that, based on its specific rules and facts and circumstances, certain persons trading such contracts (or options thereon) on the exchange will be treated as “dealers” under section 1256(g)(9).

The Service expects that, once it has reached a decision regarding the request for ruling, the same conclusion will be published in a revenue ruling, which will serve as general guidance. The Service and Treasury are committed to expedited processing for both the letter ruling and the revenue ruling.

SECTION 3. PROCEDURES

.01 Procedures for submitting a ruling request. An exchange desiring a letter ruling concerning whether certain persons trading on that exchange will qualify as dealers with respect to specific contracts traded on that exchange is required to submit a letter ruling request under the procedures provided in Rev. Proc. 2002–1, 2002–1 I.R.B. 1 (or successor procedure).

.02 Time for submitting a ruling request. Ruling requests may be submitted prior to the date on which the exchange anticipates that trading in the securities futures contracts at issue will begin, provided the exchange has developed a substantially definite framework and set of rules within which these contracts are expected to trade and has undertaken significant actions to obtain necessary regulatory approvals and to establish requisite contractual arrangements and trading systems. The Service will not rule on requests involving alternative plans of proposed transactions or hypothetical situations. See section 7.02 of Rev. Proc. 2002–1, 2002–1 I.R.B. 1, 20.

.03 Information that should be included in each ruling request. In addition to the information required by Rev. Proc. 2002–1, the exchange must submit any relevant information that will help the Service to determine whether or not persons trading in securities futures contracts on that exchange qualify as dealers under section 1256(g)(9). References to securities futures contracts include options on such contracts. References to rules applicable to trading in securities futures contracts include rules that are not yet adopted in final form but that are expected to be applicable. The current status of such rules should be described. The ruling request should also include the following:

Copies of information filed with non-tax regulatory agencies regarding trading on that exchange in the securities futures contracts at issue.

Information regarding whether persons trading in such contracts on that exchange are required to register with the Securities and Exchange Commission or the Commodity Futures Trading Commission and the nature of any required registration.

A description of any books and records requirements under federal securities laws or commodities laws to which persons trading on that exchange are subject.

Information regarding whether persons trading in such contracts on that exchange will be required to be members of the exchange and, if such persons are not required to be members of the exchange, whether such persons are required to be lessees or delegates of other persons entitled to trade at member rates on the exchange.

References to the exchange's rules, if any, to which such persons will be subject when trading in such contracts.

A description of any books and records requirements the exchange will impose on such persons and any rules granting the exchange the right to monitor and/or examine a person's trading activities and financial stability.

Information regarding whether the exchange, the Securities and Exchange Commission, or the Commodity Futures Trading Commission imposes any licensing requirements on such persons, including a description of any such requirements.

Information regarding whether the exchange imposes net capital requirements on such persons, or imposes such requirements on a clearing member firm that clears a person's trades; whether clearing firms impose any capital requirements on persons clearing trades through those firms; and, in either case, a description of any net capital requirements.

Information regarding whether the exchange requires such persons to regularly and continuously hold themselves out as willing to buy and sell securities futures contracts, regardless of market conditions; and, if the exchange imposes no such affirmative obligation, whether those persons will in fact make a two-sided market because of other factors or obligations, including a description of any such other factors or obligations.

Information regarding whether the exchange anticipates that those persons expect to profit by entering into either side of a position to capture a portion of the bid-ask spread, or whether the exchange anticipates that those persons expect that most of their gross income from trading in these securities futures contracts will be attributable to profits from market price movements.

Information regarding whether the exchange anticipates that such persons will enter into transactions to hedge their risks with respect to the securities futures contracts traded on the exchanges and the nature of such hedges.

An estimate of the average gross trading volume that the exchange anticipates such persons will generate with regard to these contracts.

Information regarding whether the exchange anticipates that trading in these securities futures contracts will be a substantial part of the principal business activity of such persons. Such information might include, for example, an estimate of the average percentage of gross income that the exchange anticipates such persons will generate from trading in these securities futures contracts.

Information regarding whether the exchange will impose a substantial presence requirement or a trading activity requirement on such persons, including a description of any such requirements.

An estimate of the volume of proprietary trading, compared to the volume of trading for customers, that such persons are expected to generate on the exchange.

A description of the exchange's trading environment (e.g., floor trading or screen trading) and any special features of such environment that differentiate the persons for whom dealer status is sought from other exchange participants.

A discussion of the nature, extent, and frequency of material changes that may occur in any of the above information after the requested ruling is issued. The exchange is encouraged to include suggestions for procedures to be followed by the exchange, its traders, and the Service in the event that material changes in the information occur. See section 12.10 of Rev. Proc. 2002-1, 2002-1 I.R.B. 1, 52; section 7.01 of Rev. Proc. 89-14, 1989-1 C.B. 814, 815.

The foregoing list of information should be provided with any ruling request, along with any additional information that may help the Service to make its determination. After its review of a request for ruling, the Service may require the exchange to submit additional information needed to make its determination. See section 10.06 and 10.07 of Rev. Proc. 2002-1, 2002-1 I.R.B. 1, 43-44.

SECTION 4. EFFECTIVE DATE

This revenue procedure is effective February 4, 2002, the date this revenue procedure was made available to the public.

SECTION 5. DRAFTING INFORMATION

The principal drafter of this notice is Shawn Tetelman of the Office of the Associate Chief Counsel (Financial Institutions and Products). For further information regarding this notice, contact Shawn Tetelman at (202) 622-3930 (not a toll-free call).